

Franchise Tax Board**SUMMARY ANALYSIS OF AMENDED BILL**Author: Soto & Scott Analyst: Marion Mann DeJong Bill Number: SB 1xxRelated Bills: See Prior Analysis Telephone: 845-6979 Amended Date: 8/20/2001Attorney: Patrick Kusiak Sponsor: _____**SUBJECT:** Electric Windfall Profits Tax/Electricity Consumers Refundable Credit

DEPARTMENT AMENDMENTS ACCEPTED. Amendments reflect suggestions of previous analysis of bill as introduced/amended _____.

AMENDMENTS IMPACT REVENUE. A new revenue estimate is provided.

☒ AMENDMENTS DID NOT RESOLVE THE DEPARTMENT'S CONCERNS stated in the previous analysis of bill as amended July 2, 2001.

☒ FURTHER AMENDMENTS NECESSARY.

DEPARTMENT POSITION CHANGED TO _____.

☒ REMAINDER OF PREVIOUS ANALYSIS OF BILL AS INTRODUCED May 17, 2001, STILL APPLIES.

OTHER - See comments below.

SUMMARY

This bill would:

- impose a windfall profits tax on sellers of electricity, and
- refund the windfall profits tax to individuals required to file an income tax return.

SUMMARY OF AMENDMENTS

The August 20, 2001, amendments made the following changes:

- Authorized the California Public Utilities Commission (CPUC) to inspect the books and records of sellers of electricity and entities required to withhold the windfall profits tax for purposes of determining the base rates and fulfilling the purposes of the windfall profits tax.
- Authorized the CPUC to re-evaluate base prices.
- Defined "reasonable allowance for profit margins and maintenance and operating expenses."
- Specified that corporations required to pay the windfall profits tax cannot claim a deduction for that tax on their corporate franchise or income tax return.
- Required the CPUC to notify the Franchise Tax Board (FTB) of all "obligations" of sellers under the windfall profits tax.
- Attempted to clarify that a withholding entity is liable for the windfall profits tax.
- Authorized exemptions from all or part of the windfall profits tax for cogeneration.

Board Position:

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Legislative Director

Date

Brian Putler**08/21/01**

- Specified that a taxpayer can bring action for denial of a claim for refund against the CPUC, rather than FTB, in Superior Court through the same process used for franchise tax and income tax purposes.
- Required FTB and the CPUC to report annually to the Legislature regarding the windfall profits tax.
- Made minor technical changes.

The August 20, 2001, amendments resolved the department's technical considerations and resolved some of the department's implementation concerns. The "This Bill," "Implementation Concerns," and "Technical Considerations" discussions from the prior analysis have been updated to reflect the August 20, 2001, amendments. In addition, the "Position," "Fiscal Impact," "Economic Impact," "Legal Impact," and "Arguments/Policy Concerns" discussions are provided below for convenience.

The "Purpose of the Bill," "Effective/Operative Date," "Background," "Federal/State Law," "Legislative History," and "Other States' Information" discussion from the departments analysis of the bill as introduced May 17, 2001, still apply.

POSITION

Oppose.

At its June 27, 2001, meeting, the Franchise Tax Board voted 2-0 to oppose this bill as amended May 17, 2001, with Annette Porini, on behalf of Member B. Timothy Gage, abstaining.

THIS BILL

Windfall Profits Tax

This bill would impose a windfall profits tax on sellers of electricity. The windfall profits tax would be equal to 100% of the amount by which the sales price of electricity sold in this state exceeds the base price. The windfall profits tax would apply only to transactions of wholesale electricity that are the last transactions prior to supplying the electricity at retail to California customers, not every transaction in the distribution chain. In addition, the tax would not apply to sales of electricity made pursuant to a binding written contract executed on or before the effective date of the bill.

The CPUC would be required to notify FTB of all "obligations" of sellers under the windfall profits tax. The CPUC could, by regulation, authorize exemptions from all or part of the windfall profits tax for generators of renewable energy sources and cogeneration.

Corporations required to pay the windfall profits tax could not claim a deduction for that tax on their corporate franchise or income tax return.

"Base price" would mean the price developed and approved by the CPUC on a plant-by-plant basis that is equivalent to the cost based rates. The "cost based rates" would mean the cost of producing electricity as adjusted for a reasonable allowance for profit margins and maintenance and operating expenses. "Reasonable allowance for profit margins and maintenance and operating expenses" would mean an amount up to a 20% return on invested capital or other rate of return on invested capital as determined by the CPUC.

The bill would grant specific authority to the CPUC to inspect the books and records of sellers to determine the base price and fulfill the purpose of the windfall profits tax. The CPUC could reevaluate the base prices as necessary. In addition, a taxpayer could submit a written application to the CPUC requesting a reevaluation of the base price. The CPUC would be required to respond to the request within 60 days.

“Sellers of electricity” would include any entity, regardless of classification, that is a producer, generator, wholesaler, marketer, broker, or other vendor of electricity.

The California Independent Systems Operator (CA-ISO), any utility distribution company, or any other person or entity in this state that processes or is required to process sales of electricity would be required to withhold 100% of the windfall profits tax from payments made to sellers. The tax would be remitted to the Franchise Tax Board (FTB) by the 15th day of the month following the month the tax is withheld. Every withholding entity would itself be liable for the windfall profits tax. Interest and the penalty for failure to pay tax by the due date would be assessed on amounts withheld and not remitted on or before the due date. In addition, the withholding entity would be required to file a monthly return to FTB showing:

- the seller's name,
- the seller's tax identification number,
- the total number of megawatt hours of electricity sold that was subject to the windfall profits tax,
- the total amount of kilowatt hours of electricity sold,
- the purchaser of the electricity, and
- other information FTB deems necessary.

A seller whose sales of electricity are not processed through CA-ISO, a utility distribution company, or any other person or entity is required to remit 100% of the windfall profits tax to FTB by the 15th day of the month following the month the sale occurred. Interest and the penalty for failure to pay tax by due date would be assessed on amounts not remitted by the due date. The seller would also be required to file a monthly return to FTB.

Penalties for failure to file a return by the due date would be assessed if a taxpayer, whether the withholding entity or the seller of electricity, did not file the monthly return with FTB by the due date.

The amount withheld and remitted would be presumed to be the windfall profits tax owed, unless the seller requested a refund. The seller must explain the reasons and facts that demonstrate why the tax withheld and remitted did not accurately reflect the tax owed.

The base price set by the CPUC would be presumed to reflect the taxpayer's cost of selling electricity. The taxpayer could dispute the base price by filing a claim for refund providing the reasons and calculations that demonstrate that the base price does not reflect the taxpayer's actual costs of selling electricity.

Claims for refund filed on the grounds that base price fails to reflect the taxpayer's actual costs of selling electricity would be reviewed by the CPUC and no refund would be issued unless the CPUC determines that the taxpayer demonstrates that an adjustment should be made to the base price. The refund amount, if any, would be calculated and approved by the PUC. Claims for refund would be filed within four years from the date the tax was required to be remitted or within one year from the date the tax was remitted, whichever period is longer. Interest would be allowed on any amounts refunded from the date of the overpayment of tax to the date the refund is issued. The interest rate would be the same rate used for income tax purposes. If the CPUC denies a claim for refund, the taxpayer may file a suit for refund in Superior Court according to the procedures for filing a suit for refund under the income tax laws.

The bill specifies that FTB shall administer the windfall profits tax according to its authority under the Administration of Franchise and Income Tax Laws and Regulations. The bill also specifically expands FTB's statutory lien authority for collection of unpaid franchise and income taxes to include unpaid windfall profits tax.

This bill would require the FTB and CPUC to report annually to the Legislature regarding the windfall profits tax. The report would include amounts collected by class and size of generation.

Electricity Consumers Refundable Credit

Any windfall profits tax due and payable, less any windfall profits tax refunds allowed to windfall profits taxpayers for the taxable year, would be distributed in equal amounts, via a tax credit, to individuals required to file an income tax return for that taxable year. Credit amounts in excess of a taxpayer's tax liability would be applied first against any other amounts due from the taxpayer, and then refunded. FTB would determine the amount of the credit. The credit amount would be unknown until the total windfall profits taxes due and payable as well as windfall profits tax refunds were determined for the taxable year and were no longer disputed and all individuals required to file income tax returns had been determined.

IMPLEMENTATION CONCERNS

Windfall Profits Tax

Since the total tax amount would be withheld and remitted monthly to the department, the windfall profits tax would be administered outside current income tax forms and processes. The department would need to develop new forms, programs, and operations to administer this new tax. Data regarding amounts collected by class and size of generation would need to be collected for purposes of the annual report to the Legislature. Department staff is reviewing the bill and developing a strategy for implementation. However, withholding of taxes is currently a program administered by the Employment Development Department. EDD has ongoing business constituents that comply with employee tax withholding requirements. That department may be able to quickly implement the provisions of this new withholding program.

The following implementation concerns relating to the windfall profits tax have been identified with this bill. Department staff is available to assist with any amendments to resolve these concerns.

- The windfall profits tax would be effective immediately upon enactment and would become operative on the first day of the first month commencing more than 60 days after the effective date. Withholding amounts would be required to be remitted within 45 days from that operative date. Department staff is concerned that forms and processes could not be developed in time to process the remittance of the windfall profits tax.
- The bill contains several undefined terms. Undefined terms can lead to disputes between taxpayers and the department. Definitions should be provided for the following terms:
 - “Sales of electricity sold in this state.” The windfall profits tax is based on the “sales price of electricity sold in this state.” Although the bill specifies that the windfall profits tax only applies to the final sale prior to distribution to retail customers, this definition is overly broad and could be disputed. In addition, the bill does not address whether a sale of electricity is considered to be “in this state” if the seller is not certain where the electricity will ultimately be used.
 - “Producer,” “generator,” “wholesaler,” “marketer,” “broker,” and “vendor.” These terms are all included in the definition of “sellers of electricity.” Although these terms appear to have an industry meaning, without specific definitions it is unclear exactly how the windfall profits tax applies to some of these sellers. For example, some “brokers” simply place the buyer and seller together for a fee and, since they do not take title to the electricity being sold, are not involved in the actual sale as a reseller.
 - “Utility distribution company” and “person or entity in this state that process or is required to process sales of electricity.” These terms describe entities required to withhold the windfall profits tax. It is unclear how someone “required to process a sale” that does not “process the sale” would withhold the tax. Further, it is unclear whether the State of California would have an obligation to withhold the tax. Department staff understands that the Department of Water Resources is a major purchaser of electricity.
- The bill provides a presumption that the tax required to be withheld and remitted is the full amount of any windfall profits tax owed by the seller (page 9, lines 17 through 20 of the bill). The bill does not specify if the presumption is rebuttable. Further, it is unclear how the presumption applies if a taxpayer argues that the tax should not apply because there is not sufficient nexus to tax. Since the bill provides a claim process where the taxpayer can dispute the tax, the purpose of the presumption is unclear.
- It may be difficult for taxpayers, persons required to withhold the tax, and department staff to determine if a sale is for “electricity sold in this state.”
- Department staff would not know when a sale occurred to enforce withholding or collection of the tax. It appears that the requirement that the CPUC notify FTB of all “obligations” of sellers is intended to resolve this concern. However, “obligations” is a broad term and may not result in the CPUC providing the department with all the information necessary for enforcement or collection purposes.

- The bill is internally inconsistent about whether the person required to withhold the windfall profits tax is liable for the tax. On page 7, lines 17 through 19, the bill specifies that the person required to withhold is liable for the windfall profits tax. However, on page 8, lines 10 through 12, the bill specifies that a person required to withhold the tax would be liable if the tax was not withheld as required or was withheld but not remitted to FTB. Further, the provision on page 8 was added to the section requiring sellers of electricity to remit the tax (Section 33003) rather than to the section requiring a person to withhold and remit the windfall profits tax (Section 33002). It appears that the author intended to resolve the department's concern about the person withholding the tax being liable for the windfall profits tax rather than the seller being liable for the tax. If this is the case, the bill should be amended to delete page 7, lines 17 through 19, and replace them by moving the provision from page 8 (lines 10 through 12) to page 7.
- The bill requires the seller to remit the tax by the 15th day of the month immediately following the month in which the *sale* occurs. The bill does not specify how to treat long-term contracts where the "sale" occurs immediately upon execution of the contract but payment is made over a period of time. As drafted, it appears that the seller would be liable for the tax at the time of sale, regardless of whether payment was ever actually received.
- The bill provides a method for sellers to dispute the tax amount, the amount withheld and remitted, and the base price. The bill requires the seller to file a claim for refund, but does not specify the procedure for filing the claim or whether to file the claim with FTB or CPUC. Since the bill specifies that the CPUC review the claim, it appears that such claims would be filed with the CPUC.

Electricity Consumers Refundable Credit

The following implementation concerns relating to the credit have been identified with this bill. The department's staff is available to assist with any amendments to resolve these concerns.

- The amount of the credit is based on the amount of windfall profits tax less any refunds of the tax allowed for the taxable year. Claims for refund of the windfall profits tax can be filed as late as four years from the date the tax was required to be remitted or within one year from the date the tax was actually remitted. Consequently, the amount of the credit cannot be determined until all claims for refund of the windfall profits tax are received and resolved.
- The bill implies that the credit is to be claimed on the income tax return since the credit would be applied against the taxpayer's net tax liability for the taxable year. However, the credit amount for all individuals cannot be determined until all returns are filed for the taxable year because the number of individuals who file income tax returns is a necessary variable in the calculation of the credit amount. Further, the bill does not specify how to determine the credit amount when taxpayers who are required to file do not file timely (e.g., taxpayers that file after requested to do so through the department's filing enforcement program). The author might consider changing the refundable credit to a rebate that can be offset by amounts owed to the state prior to being rebated.

- It is unclear when the credit would become operative because the bill provides two different operative dates for the credit. The credit section (page 4, lines 15 and 16 of the bill) specifies that the credit is operative for taxable years beginning on or after January 1, 2001. However, language provided at the back of the bill (page 10, lines 33 to 35) specifies that the provisions of the act shall become operative on the first day of the first month commencing more than 60 days after the effective date of this act.
- The phrase "individuals required to file an income tax return" should be defined. Department staff is currently interpreting this to mean anyone who meets the income thresholds that would require an individual to file an income tax return. The statute would not authorize a credit for those who file and are not required to do so because their income is below the income thresholds. For example, an individual with income below the filing threshold that files a return to receive a refund of withheld taxes.
- This bill would require regular appropriations by the Legislature to pay for the refundable credit. The author may want to consider establishing a special fund into which the excess profits tax would go, together with a statutory continuous appropriation of those funds to authorize payment of the refunds apart from the state general fund and annual budget processes.

If sufficient funds were not appropriated to cover all of the refunds due, the department would suspend payment of the refunds until additional funds were appropriated. Interest would have to be paid to refund recipients for the period of time the refund was delayed. This delay would result in additional contacts to the department by refund recipients, which would likely increase departmental costs.

- Low-income individuals generally file their tax returns on Form 540A or the postcard-size Form 540 2EZ. To minimize the complexity of Form 540 2EZ, the only credit allowed on that form is the nonrefundable renters' credit. The department could not add this proposed credit to the Form 540 2EZ as this form does not accommodate attached schedules due to its size. As a result, taxpayers that would normally file on Form 540 2EZ would be required to file the more complex Form 540A to claim the credit.
- Since the proposed credit is refundable, the credit would need to be shown in the payment section on all personal income tax (PIT) returns except the Form 540 2EZ. This could increase PIT return Forms 540, 540NR, 540X, and potentially the 540A by one page. Adding a page to these forms would result in a significant impact on FTB's operations and costs, would slow return processing, and would increase the amount of return storage space. The department may be required to lease additional office and file storage space; however the department would work within available space to the extent possible.
- If this credit is interpreted to be a state public benefit, the proposed credit falls under the federal provisions making certain aliens ineligible for state public benefits. To establish eligibility, the claimant must declare himself/herself to be a citizen of the United States or an eligible alien. The FTB has no method in place to easily verify alien eligibility, and the volume of claims for this credit is anticipated to be large.
- An undetermined number of fraud investigators may be required by the department to verify this credit. Administrative costs of such investigators have not been determined at this time.

TECHNICAL CONSIDERATIONS

On page 4, lines 11 and 12, "taxpayers required to withhold" should be changed to "entities required to withhold."

On page 9, line 15, "Section 393.5" should be changed to "Section 383.5."

On page 10, line 30, "credit" should be added after "income tax."

FISCAL IMPACT

The department's costs to administer this bill cannot be completely determined until implementation concerns have been resolved. However, department staff anticipates that the bill would need to be amended to add supplemental appropriations for FTB's fiscal year 2000-01 budget and to appropriate funds for FTB's fiscal year 2001-02 budget to administer this bill. It is estimated that costs would range from \$9.8 million to \$10.5 million.

ECONOMIC IMPACT

Any revenue attributable to the windfall profits tax would be offset by equal amounts of refundable credits distributed to individuals required to file an income tax return. Thus, there would be no revenue impact. In terms of cash flow timing between fiscal years, revenues collected would precede disbursements.

LEGAL IMPACT

Some sellers of electricity that have profited from the California energy crisis may not be impacted by the windfall profits tax because they do not have sufficient nexus in California. Although withholding the tax from the seller's payment would bring the tax into California, it is unknown whether the tax could withstand constitutional challenge.

The 100% tax rate could be considered confiscatory under the due process clause.

The windfall profits tax could be considered an indirect price regulation. Electricity price regulation is within the jurisdiction of the Federal Energy Regulatory Commission. This tax could be viewed as preempted by federal laws or regulations, and thus unconstitutional.

The "windfall profits tax" could be construed to be an income tax. If it is considered to be a tax on income and electricity is considered to be tangible personal property, the imposition of the windfall profits tax might be subject to P.L. 86-272.

The law is unclear regarding whether or not electricity is tangible personal property. The legislative intent included in the bill (page 3, line 16 of the bill), uses the phrase "electrical services." That phrase could be interpreted to reflect the legislature's intent that electricity is not tangible personal property.

ARGUMENTS/POLICY CONCERNS

- This bill could be viewed as inequitable as it would impose an additional tax on a single industry that already is subject to state taxation to the extent of any income derived from California sources. On the other hand, this industry has been perceived as excessively driving up the cost of electricity for profit.
- This bill would provide a credit only to those individual taxpayers required to file a tax return. Thus, this bill would not help individuals that do not have a California filing requirement or business entities, which also have been impacted by high electricity costs. However, amending the bill to allow the credit to all individuals and requiring them to file tax returns to claim the credit would significantly impact the department's programs and costs. In addition, the bill could provide a benefit to individuals who receive power from a municipal utility district or other utility that has controlled costs and thus not subjected its ratepayers to the same price increases as other utility companies.
- To the extent that the taxpayer claimed a deduction on their federal return for state taxes paid, any credit applied against a taxpayer's state tax liability could be considered income that would be required to be reported on the federal income tax return for the year the credit is received.
- Historically, refundable credits, such as the former state renter's credit and the federal Earned Income Credit, have had significant problems with invalid and fraudulent returns. These problems are aggravated if a refund is made that is later determined to be fraudulent. In such cases the refund commonly cannot be recovered.
- Currently, electronically filed (E-file) returns have no paper documentation processed or stored by the department. The federal Title IV provisions may require E-file taxpayers to submit paper documentation to verify eligibility, which would reverse the electronic paperless trend and pose processing and storage issues.
- Part-year residents or nonresident taxpayers would receive the full benefit of this bill even though they may not be experiencing California's energy crisis.
- The bill would allow the credit to a taxpayer that can be claimed as a dependent by another taxpayer. For example, a minor child who has income from baby-sitting or lawn mowing may separately file and receive a credit.
- This bill does not contain a sunset date. Sunset dates generally are provided to allow periodic review by the Legislature.

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